

UNITED STATES OF AMERICA  
POSTAL REGULATORY COMMISSION  
WASHINGTON, DC 20268-0001

Competitive Product Prices  
Inbound International Expedited Services 2  
(MC2009-10)

Docket No. CP2012-52

PUBLIC REPRESENTATIVE COMMENTS ON  
POSTAL SERVICE NOTICE OF FILING CHANGES IN RATES  
NOT OF GENERAL APPLICABILITY FOR INBOUND  
INTERNATIONAL EXPEDITED SERVICES 2

(August 27, 2012)

The Public Representative hereby provides comments pursuant to Order No. 1436.<sup>1</sup> In that Order, the Commission established the above referenced docket to receive comments from interested persons, including the undersigned Public Representative, on the Postal Service's Notice of a change in rates not of general applicability for the Inbound International Expedited Services 2 product, effective January 1, 2013.<sup>2</sup> No classification changes are proposed for Inbound International Expedited Services 2.<sup>3</sup>

Pursuant to 39 CFR §3015 the Postal Service is required to file notice of a change in rates not of general applicability for the Inbound International Expedited Services 2 product at least 15 days prior to the effective date of such rates. In accordance with the provisions of the Express Mail Service (EMS) Cooperative of the UPU, "rates for delivery of inbound Express Mail International must be communicated to the UPU by August 31 of the year before which they are to take effect."<sup>4</sup> As a member

---

<sup>1</sup> PRC Order No. 1436, Notice and Order on Changes in Rates Not of General Applicability, August 16, 2012.

<sup>2</sup> Notice of the United States Postal Service of Filing Changes in Rates Not of General Applicability and Application for Non-Public Treatment of Materials Filed Under Seal, August 13, 2012 (herein Notice).

<sup>3</sup> Notice at 3. Inbound International Expedited Services 2 is the product name on the competitive product list. The inbound international expedited services offered as part of this product are often times referred to as Inbound Express Mail Service (EMS). These names will be used interchangeably.

<sup>4</sup> PRC Order No. 515, Notice and Order Concerning Filing of Changes in Rates for Inbound International Expedited Services 2, Docket No. CP2010-90, August 12, 2010, at 2.

of the EMS Cooperative, the Postal Service may not change its inbound EMS rates for the coming year after August 31<sup>st</sup>. *Id.* at 2-3.

## COMMENTS

The Public Representative has reviewed the financial model, filed under seal, which estimates the expected contribution and cost coverage for the Inbound International Expedited Services 2 product during Calendar Year (CY) 2013 using the proposed rates presented in the Postal Service's Notice. The CY 2013 financial model purports to show that the proposed rates will generate sufficient revenues to cover costs.

Based upon a review of the model and recent financial results for Inbound EMS, the Public Representative finds that the Postal Service's CY 2013 financial model does not properly reflect key factors likely to affect actual results for Inbound EMS. As a result, the CY 2013 financial model fails to provide a sufficient margin of safety by manufacturing a positive cost coverage based upon assumptions that are more optimistic than actual financial results are likely to be. In this regard, the CY 2013 financial model represents a departure from all previous financial models used to project the financial performance of Inbound EMS as it relies on data not previously presented to the Commission and includes assumptions that are unrealistic. Each of these changes serves to increase the projected cost coverage compared to previous financial models. The Public Representative concludes that the financial model is not a realistic projection of future financial performance and, as a result, the proposed CY 2013 rates for inbound EMS are unlikely to generate sufficient revenues to cover costs.

*Background.* The Postal Service's Notice begins the process of establishing new Inbound EMS rates and follows the Commission's most recent Annual Compliance Determination reviewing the FY 2011 financial results and service performance of the Postal Service.<sup>5</sup> In the 2011 ACD, the Commission observed that FY 2011 was "the second year in which revenues for the Inbound International Expedited Services 2

---

<sup>5</sup> 2011 Annual Compliance Determination, Docket No. ACR2011, March 28, 2012 (2011 ACD).

product did not cover attributable costs using either the booked or imputed accounting methods.” *Id.* at 163.

In the 2011 ACD, the Commission also reviewed the difference between the FY 2011 actual financial results and the projected financial performance presented in the financial model supporting the CY 2011 rates that were in effect during the last three quarters of FY 2011. That financial model, based upon the imputed method, projected that the CY 2011 rates would generate sufficient revenues to cover costs.<sup>6</sup> In response to a Commission request the Postal Service updated the original financial model and noted that the original model “used the FY09 ICRA as the basis for projecting costs into . . . CY 2011.”<sup>7</sup> The updated model used FY 2011 ICRA data for the first three quarters of CY 2011 and projected the last quarter of CY 2011 using the latest inflation factors plus a cost contingency factor. *Id.* Based upon this update, the Postal Service observed that “Although higher than anticipated costs exacerbated the [difference between projected and actual performance,] lower than projected volume, weight and resulting revenue were the major causes of the difference . . .” *Id.* As a result, the Commission found that the Postal Service’s financial models “showing that the calendar year prices in effect during the past two fiscal years will cover attributable costs are not reflected in the actual financial performance.” 2011 ACD at 163.

The Commission concluded that for FY 2011, “the Inbound International Expedited Services 2 product did not comply with section 3633(a)(2)” of the Postal Accountability and Enhancement Act (PAEA). *Id.* The Commission then ordered the Postal Service “to take corrective action.” *Id.* In this regard, the Commission encouraged the Postal Service to conclude separate bilateral agreements with foreign postal operators “that will generate a positive cost coverage for Inbound EMS.” *Id.* In the alternative, the Commission recommended that “in future financial models the Postal Service increase the cost contingency factor used for setting Inbound International Expedited Services 2 rates.” *Id.*

---

<sup>6</sup> United States Postal Service FY 2011 Annual Compliance Report, Docket No. ACR2011, December 29, 2011, at 64.

<sup>7</sup> Response of the United States Postal Service to Chairman’s Information Request No. 1, Question 34, Docket No. ACR2011, January 27, 2012.

With respect to the action recommended by the Commission, the Postal Service did not increase the cost contingency factor in its CY 2013 financial model. To the contrary, the Postal Service eliminated the cost contingency factor from its financial model.

As discussed more fully below, the Postal Service's CY 2013 financial model also incorporates other changes that depart significantly from all previous financial models for Inbound EMS, and therefore presents an unrealistic projection of the future financial performance of Inbound EMS in CY 2013 based upon the proposed rates. These include use of "revised" Inbound EMS volumes from the Foreign Post Settlement (FPS) system in lieu of the Inbound EMS volumes presented in the FY 2011 International Cost and Revenue Analysis (ICRA) report, and elimination of the adjustment to revenue for the percentage of delivery scans missed pursuant to the EMS Pay-for-Performance plan.

*Financial Model.* In the CY 2013 financial model, projected unit costs for Inbound EMS are developed using mail processing, delivery and other costs, as well as air and surface transportation costs reported in the FY 2011 ICRA.<sup>8</sup> These costs are projected more than two years into the future, from FY 2011, through CY 2013, using inflation factors developed by Global Insight Analysis (July 2012), and then divided by a projected volume of Inbound EMS in CY 2013.<sup>9</sup>

In all previous financial models projecting the financial performance of Inbound EMS, the Postal Service has included a cost contingency factor to adjust unit costs higher. Such a factor is used to compensate for the inherent uncertainty of projecting both inflation and volumes more than two years into the future. Given the continuing rise in postal costs, the cost contingency factor is designed to guard against underestimating inflationary increases in such costs. The factor is also used to account for unknown events. In modeling the financial performance of international products,

---

<sup>8</sup> Docket No. ACR2011, Library Reference USPS-FY11-NP2, Excel file Reports.xls, worksheet tab CRA Staging; see also Library Reference USPS-FY11-NP2, Excel file Domestic Tran Calcs.xls file, worksheet tab annual.

<sup>9</sup> Inbound\_EMS\_2012.08.13.xls, worksheet tab 02\_Inputs, Source: [Bq] to [Dbx].

one important “unknown” is exchange rate fluctuations that in the case of Inbound EMS could adversely affect revenue.

The Postal Service seeks to justify its decision to eliminate the cost contingency factor as a “discretionary decision” of management.<sup>10</sup> It cites the “anticipation of future cost savings from various initiatives to be implemented in FY 2013 that would tend to have the effect of reducing mail processing costs.” *Id.* While recognizing the Commission’s recommendation of a higher contingency, the Postal Service “believes in this instance that the use of a contingency . . . need not be utilized for purposes of estimating future costs of inbound EMS.” *Id.*

The Postal Service’s “discretionary decision” to eliminate the cost contingency factor is inappropriate and not credible. As noted above, the cost contingency factor compensates for the inherent uncertainty in projecting volumes and inflationary cost increases into the future, and to account for unknown events. The claimed future mail processing cost savings represent intended management action and are not a function of inflation. Moreover, these speculative cost savings are unexplained and not quantified. To be evaluated properly, they should be identified, explained and incorporated into the financial model as reductions in the FY 2011 mail processing to which a cost contingency factor is applied.

Of course, inflationary increases in postal costs may be less than projected and unknown events could have a positive impact on cost or revenues. However, a comparison of the Postal Service’s financial models projected financial performance for rates implemented in CY 2010 and 2011 with actual financial results do not suggest such a likelihood. These financial models have consistently underestimated costs and over estimated revenues as show in the FY 2010 and 2011 financial results that encompass 7 of the 8 quarters of CY 2010 and CY 2011. In this regard, unfavorable exchange rates, and a net increase unit domestic mail processing, delivery and other costs, and domestic transportation, have exceeded the inflation-adjusted costs projected in the financial models. The resulting cost coverage is not only less than

---

<sup>10</sup> Inbound\_EMS\_2012.08.13.xls, worksheet tab 02\_Inputs, Source: [Ach].

projected but revenues do not cover costs. More importantly, actual financial results deteriorated during the period. Using the imputed method, actual “financial results did not improve as both revenue and contribution decreased between FY 2010 and FY 2011.” 2011 ACD at 162.

Moreover, not only did all previous financial models include a cost contingency, the factors used were identical. Applying the same cost contingency factor used in all previous financial models in the CY 2013 financial model results in projected costs exceeding revenues.

Another change in the CY 2013 financial model is the use of “revised” FPS volumes in lieu of the FY 2011 ICRA volumes. The revised FPS volume figure for Inbound EMS is greater than the Inbound EMS volume figure reported in the FY 2011 ICRA. The Postal Service acknowledges that use of the higher, revised FPS volume figure “in the denominator of the unit cost calculation results in a lower unit cost.”<sup>11</sup> The Postal Service also uses the higher FPS volume figure in estimating total revenue.<sup>12</sup> The effect of using the FPS volume figure is to increase total revenue and the cost coverage for Inbound EMS compared to the ICRA volume.

The Postal Service attempts to justify its use of the “revised” FPS volume figure stating that unlike the ICRA, “[v]olume and weight in the FPS are updated retroactively . . .” and therefore “it is more accurate to use the revised FPS volume figure to determine the unit cost of Inbound EMS.” *Id.* However, the CY 2013 financial model is the first model in which the Postal Service has used “revised” FPS volumes for projecting unit costs and total revenue for Inbound EMS. As a result, the FY 2011 “revised” FPS volumes for Inbound EMS are unknown to the Commission. More specifically, the Postal Service has not presented the development of the FY 2011 “revised” FPS volume figure for Inbound EMS and therefore it is not clear how the “revised” FPS volume figure differs from the FPS volume figure, or from the FY 2011 ICRA volume.

---

<sup>11</sup> Inbound\_EMS\_2012.08.13.xls, worksheet tab 02\_Inputs, Notes.

<sup>12</sup> Inbound\_EMS\_2012.08.13.xls, worksheet tab 02\_Inputs, Source: [Aa] to [Bfa]: FY11 FPS Inbound EMS.xls; The Postal Service states that the “Revised FPS volume is used to maintain consistency with the volume used to determine unit costs on the inputs tab.” *Id.*

In addition, unlike the Inbound EMS volume presented in the FY 2011 ICRA, the “revised” FPS volume figure was not relied upon by the Commission in the 2011 ACD. While the Commission has approved the FPS methodology for developing volumes, revenues and costs for all inbound products, the “revised” FPS volume figure was not presented to the Commission during its review of the Postal Service’s Annual Compliance Report (ACR) and therefore was not audited by, and does not represent the established methodology of, the Commission. For consistency with the ACD, and all previous financial models, the “revised” FPS volume figure should not be used by the Postal Service.

In another departure from all previous financial models projecting the financial performance of Inbound EMS, the Postal Service’s CY 2013 financial model removes a revenue adjustment for missing delivery scans. Since January 2007, pursuant to the Pay-for-Performance Plan of the EMS Cooperative, Inbound EMS revenues have been adjusted based upon the absence of delivery scan data.<sup>13</sup> The Postal Service does not explain the removal of this adjustment from the CY 2013 financial model. By removing this adjustment, however, the Postal Service is claiming that it provides all delivery scan data—a claim that is contrary to the most recent EMS Cooperative report card. The effect of removing this adjustment is to increase projected total revenues and the projected cost coverage for Inbound EMS in the CY 2013 financial model.

## **CONCLUSION**

The Postal Service’s CY 2013 financial model represents a significant departure from all previous financial models used to project the financial performance of Inbound EMS. The changes to the CY 2013 financial model, including the elimination the cost contingency factor and the Pay-for-Performance penalty percentage, are problematic. Elimination of the cost contingency factor is contrary to the Commission’s recommendation in the 2011 ACD and previous financial models, and the removal of the Pay-for-Performance penalty percentage is contrary to the facts. The financial model also manufactures a cost coverage that is contrary to actual financial results

---

<sup>13</sup> Response of United States Postal Service to Chairman’s Information Request No. 1 and Notice of Filing Responsive Materials (Under Seal), Docket Nos. MC2009-10/CP2009-12, December 12, 2008, Question 1.

during the past two fiscal years. Moreover, these changes, including use of the “revised” FY 2011 FPS volume figures in lieu of the FY 2011 ICRA volume for Inbound EMS, are problematic because they all have the same effect of reducing unit costs, increasing total revenues, or both. The result is a higher projected cost coverage than if the Postal Service had used the same realistic assumptions from previous financial models updated for FY 2011 ICRA costs and volumes, and higher than the likely financial results for Inbound EMS.

As a condition of approving the proposed Inbound EMS rates for CY 2013, the Commission should require the Postal Service to provide the “revised” FY 2011 FPS volumes developed in the Excel file “FY11 FPS Inbound EMS.xls.” In addition to the Excel file, the Postal Service should explain any differences between the FY 2011 ICRA volume and both the “revised” FPS volume figure for Inbound EMS used in its CY 2013 financial model and the “unrevised” FPS volume for Inbound EMS. Moreover, the Postal Service should be directed to identify and explain the anticipated future initiatives designed to reduce mail processing costs and used to justify the Postal Service’s elimination of the cost contingency factor. The Postal Service should also quantify the expected cost savings from these initiatives, and provide a schedule of their intended implementation. Finally, the Postal Service should be ordered to provide the CY 2013 financial model using the Inbound EMS volume and costs from FY 2011 ICRA, as well as the cost contingency factor from previous financial models, and the Pay-for-Performance delivery scan adjustment factor from the most recent EMS Cooperative report card.



The Public Representative respectfully submits the foregoing comments for the Commission's consideration.

---

James F. Callow  
Public Representative

901 New York Ave. NW  
Washington, DC 20268-0001  
202-789-6839  
callowjf@prc.gov